LIBRARY
SUPREME COURT, U. S.

SUPREME COURT, U. S.
FILED
MAY 23 1974
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1754

INTERNATIONAL SHOE MACHINE CORPORATION,
PETITIONER,

v.

UNITED STATES OF AMERICA,
RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

EVAN Y. SEMERJIAN
HALE AND DORR
28 State Street
Boston, Massachusetts 02109
Counsel for Petitioner

Blanchard Press, Inc., Boston, Mass. — Law Printers

INDEX

Opinions Below 1
Jurisdiction 2
Questions Presented 2
Statute Involved 2
Statement of Case 3
Reasons For Granting The Writ 6
A. The Decision Below Contravenes This Court's Decision in *Malat* v. *Riddell* 6
B. The Decision Below Augments Serious Confusion And Conflict Among The Circuits 10
1. *Does "primarily" modify "for sale" or "in the ordinary course of business"?* 11
2. *Does Corn Products Co.* v. *Commissioner, 350 U.S. 46 (1955), apply to §1231 assets?* .. 12
3. *Is there a "rental-obsolescence" requirement under §1231?* 13
4. *Does §1231 require a liquidation of inventory?* 14
C. The Proper Construction Of §1231 Should Be Defined And Settled By This Court 15
Conclusion 17
Appendix A: 26 U.S.C. §1231 18
Appendix B: District Court Opinion 20
Appendix C: Court of Appeals Opinion 31
Appendix D: Court of Appeals Judgment 37
Appendix E: Court of Appeals Memorandum And Order On Petition For Rehearing 38

Table of Citations

Cases

Albright v. *United States*, 173 F.2d 339 (8th Cir. 1949) 10, 11, 13
Corn Products v. *Commissioner*, 350 U.S. 46 (1955) .. 12
Dawson v. *Thomas*, 51-1 U.S.T.C. 617 (D.N.D.Tex. 1948) 7
Deltide Fishing & Rental Tools, Inc. v. *United States*, 279 F.Supp. 661 (D.E.D.La. 1968) 12
Grant Oil Tool Company v. *United States*, 381 F.2d 389 (Ct.Cl. 1967) 7, 12

Page

Heller Trust v. *C.I.R.*, 382 F.2d 675 (9th Cir. 1967) ... 11
Hillard v. *C.I.R.*, 281 F.2d 279 (5th Cir. 1960) 14
Hollywood Baseball Association v. *Commissioner*, 352 F.2d 350 (9th Cir. 1965), *vac. & rem.*, 383 U.S. 824 (1966); S.C., 423 F.2d 494 (9th Cir. 1970) 12
Malat v. *Riddell*, 383 U.S. 569 (1966) 2, 5, 6, 7, 8, 9, 10, 11, 12
Municipal Bond Corp. v. *C.I.R.*, 341 F.2d 683 (8th Cir. 1965) 7, 9, 10, 11, 12
Municipal Bond Corp. v. *C.I.R.*, 382 F.2d 184 (8th Cir. 1967) 8
Philber Equipment Corp. v. *C.I.R.*, 237 F.2d 129 (3d Cir. 1956) 13, 14
Recordak Corp. v. *United States*, 325 F.2d 460 (Ct.Cl. 1963) 9, 11
Scheuber v. *C.I.R.*, 371 F.2d 996 (7th Cir. 1967) 11, 13
United States v. *Bennett*, 186 F.2d 407 (5th Cir. 1951) 10, 11, 13
United States v. *Healy*, 376 U.S. 75, 78 (1964) 2

Statutes

26 U.S.C. §1231 ..... 2, 5, 6, 9, 10, 14, 15
§1231(a) 6
§1231(b)(1)(A) 15
§1231(b)(1)(B) 2, 14, 15
28 U.S.C. §1254(1) 2
§1340 3
§1346(a)(1) 3
§2101(c) 2

Page

Other Authorities

Bernstein, *"Primarily For Sale": A Semantic Snare,* 20 Stan. L. Rev. 1093 (1968) 9
Comment, 45 Temple L. Q. 291 (1972) 12
Comment, 45 Tulane L. Rev. 432 (1971) 12
Comment, 23 U. Fla. L. Rev. 609 (1971) 12
Comment, 24 Vand. L. Rev. 181 (1970) 12
Hanson, "When Will The Dealer In Real Estate Receive Capital Gains?" Journal of Taxation 40 (Jan. 1970) 13
Mertens, Law of Federal Income Taxation, Code Commentary, §1221:2, p. 16 7

In the
Supreme Court of the United States

OCTOBER TERM, 1973

No.

INTERNATIONAL SHOE MACHINE CORPORATION,
PETITIONER,

v.

UNITED STATES OF AMERICA,
RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Opinions Below

The Memorandum of Decision of the District Court is reported at 369 F.Supp. 588 (D. Mass. 1973) and printed in Appendix B. The opinion of the Court of Appeals is reported at 491 F.2d 157 (1st Cir. 1974) and printed in Appendix C. The Memorandum and Order of the Court of Appeals on petition for rehearing is printed in Appendix E.

Jurisdiction

The judgment sought to be reviewed was entered on January 23, 1974. The order denying petition for rehearing was entered on February 25, 1974. Jurisdiction to review the judgment of the Court of Appeals by writ of certiorari is based on 28 U.S.C. §1254(1). This Petition has been filed within 90 days after the date on which the petition for rehearing was denied by the Court of Appeals. 28 U.S.C. §2101(c). *United States* v. *Healy*, 376 U.S. 75, 78 (1964).

Questions Presented

1. Whether the Petitioner's shoe machines, which were on lease to its lease customers for an average of eight and one half years, were not held primarily for sale to customers in the ordinary course of its trade or business, so that gains realized from their sale were taxable as capital gains under 26 U.S.C. §1231 rather than as ordinary income.

2. Whether the Court of Appeals' construction of 26 U.S.C. §1231(b)(1)(B) is erroneous and contrary to *Malat* v. *Riddell*, 383 U.S. 569 (1966).

Statute Involved

The pertinent provisions of 26 U.S.C. §1231 are lengthy and are set forth in Appendix A. The portions thereof directly in issue appear in 26 U.S.C. §1231(b)(1)(B): "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" does not qualify as "property used in the trade or business."

Statement of Case

This is a suit for refund of income taxes and interest for the years 1964, 1965 and 1966 on gains realized from the sale of shoe machines on lease for more than 6 months. Jurisdiction in the District Court was based on 28 U.S.C. §1340 and §1346(a)(1).

The Petitioner is in the business of manufacturing and leasing shoe machines. Its purpose and policy with respect to the machines in question were to lease, not to sell (A. 27, 33, 44, 51-52, 124, 156). This purpose and policy included striving to maintain its machines on lease and to get even more lease business (A. 205). Leasing was more profitable than selling (A. 27, 129), and the overwhelming majority of the Petitioner's business was in leasing (A. 212).

The Petitioner offered free service on its leased machines, but not on those it sold (A. 31). It maintained no sales force to sell machines, and did not solicit purchases (A. 35). Its salesmen received incentive payments for leases, but not for sales (A. 34, 78), and were not authorized to sell machines which were on lease (A. 34, 48, 103). Its leases contained no purchase options, and specified that the leased machinery "shall at all times remain and be the sole and exclusive property" of the Petitioner (A. 32; Ex. 16). With respect to all of its shoe machines on lease, including those in dispute, the Petitioner carried them on its books in leased equipment accounts (A. 134-5, 140), did not offer them for sale (A. 52, 53), did not advertise them for sale (A. 27), did not publish any price lists (A. 29, 31, 60, 159, 173) and did nothing to make them more attractive for sale (A. 43). Its direct mail advertising stressed the advantages of leasing (Exs. 150, 151).

During the taxable years, the shoe industry had profitable times and more cash (A. 46). At the same time, the

new investment tax credit made it attractive for some shoe manufacturers to consider buying rather than leasing (A. 46, 74). When lessees expressed a desire to purchase machines on lease, the Petitioner tried to persuade them not to buy (A. 56, 158, 204, 208-9, 210). The initiative to buy the machines in question always came from the lessee (A. 38, 39, 48, 103, 203; Exs. 264, 307-308). Unlike leasing, such matters were unusual and were referred to high-level management for consideration and decision (A. 34, 42, 56, 58, 79, 96, 97, 98, 157, 164; Exs. 301, 307). The Petitioner did all it could to resist and avoid selling its leased machines (A. 38, 66, 105, 211). It set its prices high to discourage their purchase (A. 33, 76, 209), and sold the ones in question only as a last resort (A. 37, 210, 211) after being "pushed into a corner" (A. 165), which meant pressure from an adamant customer who would throw the Petitioner out entirely if it did not sell, thus jeopardizing the Petitioner's leasing program and exposing it to competitive losses on new lease business (A. 203-205).

In the years 1964, 1965 and 1966, certain lease customers purchased from the Petitioner 147, 69 and 55 shoe machines, respectively, which had been on lease for more than 6 months at the time of purchase. The gains realized from these sales are at issue in this case. The total periods the machines in question were held by the Petitioner prior to sale were as follows:

Taxable Year	*No. of Machines*	*Average Period Held*
1964	147	7.6 years
1965	69	9.8 years
1966	55	9.1 years
Combined:	271	8.5 years

Further, most of the purchases in dispute were made in bulk by a few large lease customers, and all of them were made by lease customers with respect to machines already on lease to them (Exs. 7-15).

These purchases constituted generally less than 5% of the more than 2,600 shoe machines on lease during each taxable year (Ex. 26). At the same time, lease revenues increased but revenues from outright sales did not (Ex. 27). In fact, the revenues from the sales in dispute were only a fraction of the revenues from sales of shoe cement, and were only 3% of the total gross revenues for the same years, whereas revenues from shoe machine leases approximated 60% of the same total gross revenues (Ex. 27).

For the taxable years, the Petitioner reported capital gains from the sales in dispute in the amounts of $437,374.32, $89,845.46, and $133,201.16. The Respondent determined these gains to be ordinary income rather than capital gains on the ground that the shoe machines in question were includible in the Petitioner's inventory or held for sale to its customers in the ordinary course of business. The Respondent thereupon assessed deficiencies for these taxable years in the amounts, respectively, of $107,895.97, $20,549.48 and $30,636.27, which the Petitioner paid together with interest (Exs. 4-6). The Respondent denied the Petitioner's refund claims.

Although the District Court agreed that "generally speaking the purpose of selling its shoe machines was not of first importance to plaintiff" (Appendix B, *infra*, p. 25), and that the leased shoe machines in question were not held primarily for sale to customers under the definition of "primarily" in *Malat* v. *Riddell*, 383 U.S. 569, 572 (1966) (Appendix B, *infra*, p. 28), the District Court nevertheless concluded that the Petitioner was not entitled to capital gains treatment under §1231. The Court of Appeals affirmed, entered judgment for the Respondent,

(Appendix C and D, *infra*, pp. 31, 37), and denied the petition for rehearing (Appendix E, *infra*, p. 38).

Reasons For Granting The Writ

A. The Decision Below Contravenes This Court's Decision in *Malat* v. *Riddell*.

In relevant part, 26 U.S.C. §1231(a), provides that, "if, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business ... exceed the recognized losses from such sales [or] exchanges, ... such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months." Section 1231(b)(1) specifies that "the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months ..., which is not — (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business ...."

Thus, as prerequisites to capital gain treatment, §1231 requires that the shoe machines in question

(1) be used in the Petitioner's trade or business,
(2) be subject to the allowance for depreciation,
(3) be held for more than 6 months prior to sale,
(4) not be property of a kind properly includible in the Petitioner's inventory if on hand at the close of the taxable year, and
(5) not be held by the Petitioner primarily for sale to customers in the ordinary course of its trade or business.

The Respondent disallowed the Petitioner's claim for capital gain treatment on the ground that the machines did not qualify under requirements (4) and (5)[1] (Exs. 4-5). The Respondent did not dispute that they qualify under requirements (1), (2) and (3) (Exs. 3-5; A. 140-141, 216-217).

The key question, then, appears to be whether the shoe machines in dispute were held by the Petitioner "primarily for sale to customers in the ordinary course of its trade or business." Accordingly, it seems from the face of the statute that if the primary purpose for which the Petitioner held the shoe machines in question was for leasing, not for sale, then they should qualify for capital gains treatment.

The District Court and the Court of Appeals acknowledged that the word "primarily" in the governing clause of §1231(b)(1)(B) means "of first importance" or "principally" under *Malat* v. *Riddell*, 383 U.S. 569, 572 (1966). Although this Court in *Malat* was dealing with §1221 rather than §1231, the clause in question appears in both sections, and this Court made clear that it was construing the word "primarily" in its ordinary, everyday sense and by a literal reading, *Id.* at 571-572, a construction equally applicable to the same word in §1231. Accord, *Municipal Bond*

---

[1] Requirements (4) and (5) appear to overlap completely. The cases do not distinguish between them, concluding that if property is not held primarily for sale it is not properly includible in inventory. See, e.g., *Grant Oil Tool Company* v. *United States*, 381 F.2d 389, 397, 398 (Ct. Cl. 1967) ("Inventory is, in its present context, simply stated, property that is held for sale . . . To be consistent with the scope and purpose of §1231, 'the inventory' it excludes must be that from which the taxpayer gets his normal sales profits . . . Merchandise, to be 'properly includible' in 'the inventory' that §1231 excludes, must be held for *sale* at a profit"); *Dawson et al.* v. *Thomas*, 51-1 U.S.T.C. 617, 618 (D.N.D.Tex. 1948); Mertens, Law of Federal Income Taxation, Code Commentary, §1221:2, p. 16. In any event, the Petitioner keeps no inventory of shoe machines (A. 122-123) and the shoe machines in question would not be property of a kind includible therein.

Corp. v. *C.I.R.*, 341 F.2d 683, 686-689 (8th Cir. 1965) (a §1231 case cited with approval in *Malat* at 571 ftn. 3); *Municipal Bond Corp.* v. *C.I.R.*, 382 F.2d 184, 195 (8th Cir. 1967).

The *Malat* case involved the sale of real estate whose resulting profits the taxpayers reported as capital gains. The undisputed findings in that case were that the taxpayers, at the time of acquiring the real estate, intended either to sell the property or develop it for rental, depending on which course appeared to be most profitable. *Id.* 570. The Government argued, and the lower courts agreed ,that such a dual purpose was not entitled to capital gains treatment. This Court, however, vacated and remanded the case because the courts below applied "an incorrect legal standard" with regard to how the property was *primarily* held. *Id.* 572.

Thus, in a case where there was admittedly a *dual* purpose *at the outset* in holding property, the "primarily" test as defined by this Court was held to require a finding one way or the other as to which of the purposes was the *primary* one, and this Court obviously envisioned a plausible finding that even such a dual purpose for the entire duration of the holding period could result in capital gains treatment.

On that basis, this Court would have even less difficulty with the shoe machines in the case at bar, since the Petitioner here had no dual purpose at the outset in holding the machines, but was determined throughout to hold them as equipment for leasing, not for sale. And in fact the Petitioner held them for this sole purpose for an average of 8½ years per machine. The decision to sell each of the machines in question came much later at the end of the holding period, reluctantly and at the time of sale, at the insistence of the lease customer, and through no plan or preconception of the Petitioner. Accordingly,

these machines appear to fall clearly within the *Malat* test to qualify them for capital gains treatment.

However, both courts below openly rejected the words of §1231 and the *Malat* test. The District Court stated that "the statutory provision should yield or be ignored" (Appendix B, *infra*, p. 28). The Court of Appeals said: "We cannot agree that *Malat* is dispositive. Even if 'primarily' is defined as 'of first importance' or 'principally', the word may still invoke a contrast between sales made in the 'ordinary course of . . . business' and those made as liquidations of inventory, rather than between leases and sales" (Appendix C, *infra*, pp. 33-34). The Court below relied on *Recordak Corp.* v. *United States*, 325 F.2d 460, 463 (Ct. Cl. 1963), for this conclusion, although recognizing the legitimacy of challenges to *Recordak's* vitality in view of *Malat* (Appendix C, *infra*, p. 34). Indeed, one such criticism appears in Bernstein, *"Primarily for Sale": A Semantic Snare*, 20 Stan. L. Rev. 1093, 1114 (1968):

> [*Recordak's*] reasoning appears to run counter to the legislative history of the statute, which shows that "primarily" was *not* intended to modify "in the ordinary course of business" *but rather to invoke a contrast between holding for sale and holding for another purpose.* The *Recordak* approach, furthermore, has been undermined by *Malat*. *Recordak* distinguished only between sales inside and outside the normal course of the business, in effect ignoring the word "primarily" despite the court's implicit claim to the contrary. *This would seem to run counter to the Malat command that the word "primarily" be given literal effect* (emphasis added).

Furthermore, this Court in *Malat* approved *Municipal Bond Corporation* v. *C.I.R.*, 341 F.2d 683 (8th Cir. 1965),

for its construction of "primarily". 383 U.S. 569, 571, ftn. In *Municipal Bond,* the court (at 687) relied on *United States* v. *Bennett,* 186 F.2d 407 (5th Cir. 1951), where it was held that gains from sales of cattle culled from a breeding herd were entitled to capital gains treatment. *Bennett* was also approved in *Malat.* 383 U.S. 569, 571, ftn. In addition, *Municipal Bond* relied on *Albright* v. *United States,* 173 F.2d 339, 344 (8th Cir. 1949), where the court held that a capital gain was derived from selling culls from a dairy herd on a consistent basis, and said that "a dairy farmer is not primarily engaged in the sale of beef cattle. His herd is not held primarily for sale in the ordinary course of his business. Such sales as he makes are incidental to his business and are required for its economical and successful management."

Here, where certain shoe machines on lease were sold on an *inconsistent* basis, where there is no dispute that the Petitioner was *not* primarily engaged in selling shoe machines and where such sales were clearly *incidental* to its lease business, the court's denial of capital gains treatment runs counter to *Malat.* The crucial question nevertheless has been raised by the Court of Appeals and requires a definitive answer: What does "primarily" modify? In view of the importance of the issue with respect to all taxpayers, including the Petitioner, whose reliance on the *Malat* test in §1231 transactions has been rendered insecure in the First Circuit, granting the writ of certiorari would be most appropriate and timely in this case.

B. The Decision Below Augments Serious Confusion and Conflict Among the Circuits.

The District Court and the Court of Appeals in this case construed and applied §1231 so as to augment an

existing disarray among several federal courts. Significant questions are involved:

1. *Does "primarily" modify "for sale" or "in the ordinary course of business"?* The courts below and the Court of Claims in *Recordak* adopted views totally contrary to the approaches taken by the Eighth and Fifth Circuits in *Municipal Bond Corporation* v. *C.I.R.*, 341 F.2d 683 (8th Cir. 1965), *Albright* v. *United States*, 173 F.2d 339 (8th Cir. 1949), and *United States* v. *Bennett*, 186 F.2d 407 (5th Cir. 1951), all of which are discussed above. Indeed, unlike the First Circuit in this case, the *Municipal Bond* court also noted that, "upon the capital gain issue, purpose or intention must be determined with respect to each tract and such purpose may vary with respect to the different tracts." 341 F.2d at 689-690.

The opinion below is also contrary to the rationale of *Heller Trust* v. *C.I.R.*, 382 F.2d 675 (9th Cir. 1967), and *Scheuber* v. *C.I.R.*, 371 F.2d 996 (7th Cir. 1967) (purpose in holding the property is the test under *Malat*). In *Scheuber*, as in *Municipal Bond*, the court listed the relevant guidelines such as frequency of sales, improvements (or absence of same) to make the property more marketable, length of time the property is held, substantiality of income, purpose of acquisition and extent of advertising; and the Government agreed that these guidelines were relevant. 371 F.2d at 998. The decision below ignores these factors. Indeed, the courts in *Heller* and *Scheuber* held for the taxpayers even though the taxpayers had an intention to sell the property in question from the outset of the holding period, although it was not the *primary* intention. Here, there was no such intention to sell from the outset, and the Petitioner held the machines on lease for an average of 8½ years, received rent on them, depreciated them, repaired them for further renting, and wanted to keep them on lease throughout the holding period.

2. *Does Corn Products Co.* v. *Commissioner, 350 U.S. 46 (1955), apply to §1231 assets?* The District Court held that "generally speaking the purpose of selling its shoe machines was not of first importance to plaintiff," but denied capital gains treatment despite *Malat* by invoking *Corn Products* and concluding that "the income from plaintiff's questioned sales arose from the everyday operation of the business and did not represent liquidation of an investment" (Appendix B, *infra,* p. 25). The Court of Appeals below did not expressly cite *Corn Products,* but implicitly relied on it by affirming the District Court and relying heavily on the identical rationale (Appendix C, *infra,* p. 34). In *Corn Products* this Court held that the taxpayer's corn futures did not qualify as "capital assets" under §1221 because there was no real difference between its corn futures and its raw corn, which in no event would be a "capital asset." The reasoning and factual basis for *Corn Products* would seem to render it inapposite to the case at bar.

Extension of the *Corn Products* doctrine to §1231 assets has been explicitly rejected in *Deltide Fishing & Rental Tools, Inc.* v. *United States,* 279 F.Supp. 661 (D.E.D. La. 1968), but attempted in *Hollywood Baseball Association* v. *Commissioner,* 352 F.2d 350 (9th Cir. 1965), vacated and remanded [for further consideration in light of *Malat* v. *Riddell,* 383 U.S. 569 (1966)], 383 U.S. 824 (1966); S.C., 423 F.2d 494 (9th Cir. 1970). The *Hollywood Baseball* approach has been uniformly criticized by commentators in legal journals. *Comment,* 24 Vand. L. Rev. 181 (1970). *Comment,* 45 Tulane L. Rev. 432 (1971). *Comment,* 23 U. Fla. L. Rev. 609 (1971). *Comment,* 45 Temple L. Q. 291 (1972). At the same time, the Court of Claims has refused to extend *Corn Products* to §1231, *Grant Oil Tool Co.* v. *United States,* 381 F.2d 389, 398 (Ct. Cl. 1967). Such extension has not been successful in any other circuit, and

is plainly contrary to the approaches taken in *Municipal Bond Corporation* v. *C.I.R.*, 341 F.2d 683 (8th Cir. 1965); *Albright* v. *United States*, 173 F.2d 339, 344 (8th Cir. 1949); *United States* v. *Bennett*, 186 F.2d 407 (5th Cir. 1951); and *Scheuber* v. *C.I.R.*, 371 F.2d 996 (7th Cir. 1967). The law seems to be in utter confusion in this regard. See Hanson, "When Will the Dealer in Real Estate Receive Capital Gains?" Journal of Taxation 40 (Jan. 1970).

3. *Is there a "rental-obsolescence" requirement under §1231?* Recognizing the conflict among the federal courts, the court below sought to distinguish certain contrary decisions by characterizing them as "rental-obsolescence" decisions "which hold that the sale of rental equipment, no longer useful for renting, is taxable at capital gains rates" (Appendix C, *infra*, p. 35). However, this characterization appears erroneous since those decisions did not turn on any such factor, are inconsistent with the approach taken by the court below, appear to follow the words of §1231, and anticipate the *Malat* rationale.

For example, in *Philber Equipment Corp.* v. *C.I.R.*, 237 F.2d 129 (3d Cir. 1956), the court at great length inquired into the *purpose* of the taxpayer's holding the property in question. It may be that in *Philber* "equipment was sold only after its rental income-producing potential had ended", but that circumstance was determined by the taxpayer's decision to sell, not by any independent fact that made the equipment worthless for rental purposes. Indeed, in *Philber*, the taxpayer testified:

> "It is our intention always that we will take a fleet back to dispose of it in some manner. If we can release it favorable [sic], we rel-lease [sic] it, but if we can sell it more favorably, we will, of course, sell it." 237 F.2d at 132, ftn.

No such dual purpose is present in the case at bar. Indeed, the facts in *Philber* showed that, unlike the Petitioner here, the taxpayer in *Philber* always knew throughout the holding period that each piece of rented equipment would be sold. The fact that the "sales were the natural conclusion of a vehicle rental business cycle" was not a determining factor in that case, and was not held to be a *requirement* for capital gains treatment but rather a *circumstance* showing that the sales were *incidental* to the taxpayer's rental business. The case at bar is stronger for the taxpayer than *Philber* since the Petitioner here had no dual purpose during the holding period of each machine in question. And even under *Philber,* there is no dispute that the sales of Petitioner's shoe machines were *incidental* to its rental business.

The same approach was taken by the court in *Hillard* v. *C.I.R.,* 281 F.2d 279 (5th Cir. 1960). Rental vehicles there had a certain rental life for *depreciation* purposes. That factor was mentioned by the court only to show, as in *Philber,* that the sales of those rental vehicles were incidental to the taxpayer's rental business for purposes of determining the taxpayer's purpose in holding the vehicles under §1231. The court did not hold or even suggest, as the opinion below does, that rental equipment must become useless or worthless in order to qualify for capital gains treatment under §1231. The Petitioner has found no opinion which so holds, except for the opinions below, and it now appears that the law of the First Circuit cannot be reconciled with the law prevailing elsewhere.

4. *Does §1231 require a liquidation of inventory?* The decision below holds that the word "primarily" in §1231 (b)(1)(B) invokes "a contrast between sales made in the 'ordinary course of... business' and those made as *liquidations of inventory,* rather than between leases and sales" (Appendix C, *infra,* pp. 33-34) (emphasis added).

Later, the opinion states: "Even 'accepted and predicable' sales might not... occur in the 'ordinary course of... business'. For example, a *final liquidation of inventory*, although accepted and predictable, would normally be eligible for capital gains treatment" (Appendix C, *infra*, p. 35) (emphasis added).

The opinion cites no authority for this "inventory liquidation" concept, and the Petitioner has not found any. In fact, §1231 itself shows the concept to be erroneous, because §1231(b)(1)(A) *denies* capital gains treatment where the property in question is "property of a kind which would properly be *includible in the inventory* of the taxpayer if on hand at the close of the taxable year" (emphasis added).

The foregoing conflicts among the courts of appeals and the Court of Claims, and the confusion which now prevails in §1231 cases, warrant the granting of the writ of certiorari to review the decision below.

C. The Proper Construction of §1231 Should Be Defined and Settled by This Court.

The District Court was troubled by the "apparent inconsistency" in its opinion, and was led to the astonishing conclusion "that the statutory provision should yield or be ignored" (Appendix B, *infra*, p. 28). It attempted to "make an effort at reconciliation" and proceeded with an "ex post facto approach" (Appendix B, *infra*, pp. 28-29) and an analysis which paints with such a broad brush that, if it were truly the law, no taxpayer could predict with any satisfactory degree of certainty the tax consequences of his §1231 transactions. Indeed, the District Court admitted that "the particular leased machines which would be sold could not be identified at any particular time before sale" (Appendix B, *infra*, pp. 28-29). And, although it

concluded that "after their sale" they "had been held primarily for sale", the District Court still never identified which of them were so held, why they were different from others, and what specific facts colored these transactions. Moreover, the District Court's conclusion is plainly contradicted by its opening observation that the Petitioner had a "general purpose of holding leased machines primarily for leasing" (Appendix B, *infra*, p. 28).

The Court of Appeals acknowledged that "the case raises what has become a repeating source of difficulty in applying §1231(b)(1)(B) . . ." and posed several questions raised in this Petition (Appendix C, *infra*, p. 32). The court's observation is plainly illustrated by the numerous federal cases and law review comments already cited and discussed above.

The inequity in the present state of the law lies not only in the Petitioner's case, which it believes has been wrongly decided,[2] but also in the fact that in §1231 transactions, taxpayers in Boston, San Francisco, Atlanta and St. Louis will be governed by different rules and may well achieve different results based on the accident of their location. If their circumstances permit, they may be fortunate enough to be able to shop for the most suitable forum to resolve their tax disputes. Further, this legal

[2] The Petitioner strongly believes that the case has been wrongly decided, not only for the reasons already set forth above, but also for the reason that the opinion of the Court of Appeals contains statements and conclusions of fact which were not mentioned by the District Court and which the Petitioner believes cannot be supported and are often contradicted by the record. See Memorandum and Order denying petition for rehearing, Appendix E, *infra*, p. 38. Certain other factual statements by the District Court are also, in the Petitioner's view, not supported by the record. There is no credibility issue since the District Court decided the case on a completed record, including transcripts, without hearing any testimony, the original trial judge having withdrawn from the case after trial. However, in order to preserve the brevity of this Petition, these matters have not been detailed here. The reasons for granting the writ include, but do not turn on, these matters.

situation renders tax planning exceedingly difficult for numerous businesses across the United States, and creates perplexing uncertainties which can be finally resolved only by this Court.

Conclusion

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the First Circuit.

Respectfully submitted,

Evan Y. Semerjian
Hale and Dorr
28 State Street
Boston, Massachusetts 02109
Counsel for Petitioner

APPENDIX A

26 U.S.C.

PART IV — SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

* * * *

§ 1231. Property used in the trade or business and involuntary conversions.

(a) General rule. — If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) losses (including losses not compensated for by insurance or otherwise) upon the destruction, in whole or in part, theft or seizure, or requisition or

condemnation of (A) property used in the trade or business or (B) capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

In the case of any involuntary conversion (subject to the provisions of this subsection but for this sentence) arising from fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, this subsection shall not apply to such conversion (whether resulting in gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions.

(b) Definition of property used in the trade or business —For purposes of this section—

(1) General rule. — The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business....

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

CIVIL ACTION No. 70-317-G

INTERNATIONAL SHOE MACHINE CORPORATION,
PLAINTIFF,
v.
UNITED STATES OF AMERICA,
DEFENDANT.

MEMORANDUM OF DECISION
July 30, 1973

GARRITY, *J.* This is a tax refund suit in which the plaintiff taxpayer asserts that the Commissioner of Internal Revenue erroneously treated income realized from the plaintiff's sales of certain shoe machines as ordinary income instead of treating the income under the capital gains provisions of the Code. The court has jurisdiction under 28 U.S.C. §§ 1340, 1346(a)(1).

The plaintiff, a well-known manufacturer of shoe machinery, is a Massachusetts corporation with its principal place of business in Brighton, Massachusetts. During the years in question—1964 through 1966—the main source of its business income derived from the leases of its shoe machinery equipment to shoe manufacturers throughout the United States and abroad. During the years 1964, 1965 and 1966, plaintiff sold, respectively, 147, 69 and 55 shoe machines to customers who, at the time of the sales, had been leasing the machines for at least six months. For the taxable years in question, plaintiff reported capital gains from these sales in the amounts of $437,374.32, $89,845.46 and $133,201.16. The Commissioner's response in each instance was to assess a deficiency, on the ground

that the shoe machines in question were includable in plaintiff's inventory or were held for sale to customers in the ordinary course of business and that, in either event, the sales did not qualify under 26 U.S.C. § 1231 for capital gains treatment. The plaintiff paid deficiencies in the amounts of $107,895.97 for 1964, $20,549.48 for 1965, and $30,636.27 for 1966, with interest for all these years, and filed claims for refund, which were denied in all three cases. It then timely filed this action.[1] After trial and the filing of post-trial memoranda, a situation arose requiring the disqualification of the trial judge and the case was reassigned. The parties agreed to submit on the record, filed further memoranda and presented oral arguments.

Plaintiff contends that the income from the sales in question should be treated as capital gains under 26 U.S.C. § 1231, because the machines were not "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," § 1231(b)(1)(B). Defendant agrees that the issue before the court concerns the applicability of this quoted subsection, and the parties thus assume that the sales in question conformed otherwise to the requirements of § 1231. They assume, in other words, that the machines were "used in the trade or business" and were "subject to the allowance for depreciation provided in section 167." Plaintiff has argued that the sales in question were extraordinary events because its policy has consistently been to lease, not sell, its shoe machines. Undoubtedly plaintiff's main interest was, during the years in question and earlier, that of leasing its shoe machines. Although it sold new, non-leased machines to subsidiaries and affiliates in foreign countries and to a very few domestic companies, these sales, the income from

[1] The parties have settled a related suit, docket number C.A. 71-515-G, concerning a deduction for bad debt reserves. Judgment in that case will be entered for the plaintiff for $12,228.09 plus interest.

which plaintiff reported as ordinary income, comprised approximately 15, 6 and 6 percent of total sales during the years involved here.

Until 1963 plaintiff's sales of machines to customers then leasing the machines consistently constituted less than 1% of plaintiff's gross revenues. Plaintiff's sales to its lease customers increased tenfold in 1963 over 1962 and more than thirtyfold in 1964 over 1962; revenue from such sales between 1964 and 1966 comprised, however, only 7, 2 and 2 percent of gross revenues. Of further importance are comparisons between lease and sales revenue during the tax years in question. The ratios of lease revenues to sales of leased machines during these years were 8, 40 and 30 to 1.

While sales of leased shoe machines did not, during the tax years in question, make up a large portion of plaintiff's business, they nonetheless increased sharply in those years over prior years. Plaintiffs attribute the increase to several factors. The investment tax credit, enacted in 1962, made it attractive for shoe manufacturers to buy shoe machinery rather than lease it. Customers were also aware of the decree entered against plaintiff's principal competitor in *United States* v. *United Shoe Machinery Corporation,* D. Mass. 1953, 110 F.Supp. 295, *aff'd per curiam,* 1954, 347 U.S. 521, which ordered United Shoe, *inter alia,* not to offer to lease its machines unless it also offered to sell them. Plaintiff attributes much significance to the fact that the interest in purchasing shoe machines, rather than leasing, originated with the customer. Plaintiff points out that it never developed a sales force, never solicited purchases, often attempted to dissuade customers from purchasing, set prices high to make purchasing unattractive, and persisted, even in the face of customers' demand, in its policy of leasing shoe machinery equipment.

While these facts are pertinent, they do not paint a

complete picture. When customers expressed an interest in purchasing the machine that they were leasing, plaintiff did not simply say, "We do not sell our machines." Such a course of conduct would have been harmful to plaintiff's customer relations; not surprisingly, plaintiff did not engage in it. Paul Hirsch, plaintiff's Vice President of Sales during 1964 through 1966, testified that "if a customer asked us specifically and indicated a serious desire and wanted to talk about purchase, I mean we had no hesitation; we would tell him the price." Plaintiff adopted a policy of selling if the customer was persistent enough, and a concomitant policy of non-discrimination; as Mr. Hirsch put it, "[W]e were also aware of the fact that we have to treat everyone alike. We can't refuse to sell to some and sell to others." Plaintiff made these decisions when demand first started to increase rapidly and selling became, if not a common, at least an accepted aspect of plaintiff's business. According to Michael M. Becka, plaintiff's executive vice president and general manager, the determinations leading to these decisions included "the fact that we didn't want to lose the sale to [our] competition." After these decisions were made, it was no longer necessary for sales personnel to seek a decision from the highest level of management on each purchase request. The policy was simply to sell if the customer insisted on buying, despite the company's preferences. The customer did not have to threaten to sue plaintiff or to take his business elsewhere unless plaintiff sold. In order to maintain good relations, plaintiff agreed to sell when the customer leasing its machines evidenced a strong interest in purchasing. In a competitive market, plaintiff has no ultimate choice but to adopt these policies.

In plaintiff's view the evidence establishes that the machines leased to customers for more than six months and then sold to the lessees were held by plaintiff primarily

for lease and not for sale and, moreover, that the machines were not held and sold in the ordinary course of business because the sales were extraordinary events. We shall first state why we disagree with the latter contention. As we have found, when the demand from plaintiff's customers to purchase machines then on lease began to increase, plaintiff made a policy decision to try to dissuade the customer, but to sell if the customer insisted. The fact that plaintiff did not have a sales force is not of any particular moment, because, first, the customers initiated the negotiations and thus no selling effort was required of the plaintiff and, second, personnel trained in the leasing of shoe machines could, and did, consummate the sales themselves. Moreover, the products involved were, of course, the very same products that plaintiff leased and thus could not be said to be unusual property necessitating the hiring of specially-trained sales personnel. Finally, while the income from the sales did not constitute a major portion of the plaintiff's business, the sales were certainly substantial in number, totalling 271 over the three-year period. From the point when plaintiff decided to sell its leased machines to customers who expressed a strong desire to buy them, the plaintiff operated a business in which selling was an accepted and predictable part of its business. Plaintiff has not suggested that the machines it sold differed in any way or were initially handled in any different manner from the rest of its machines, nor has it suggested that the proceeds of the sales were used in any different manner from the proceeds of the leases. On all the facts we conclude that the 271 machines were held, and sold, in the ordinary course of plaintiff's business. See *S.E.C. Corp.* v. *United States*, S.D. N.Y. 1956, 140 F.Supp. 717.

In support of its contention that the machines in question were held by plaintiff "primarily" for lease, and not

for sale, plaintiff invokes the Supreme Court's opinion in *Malat* v. *Riddell,* 383 U.S. 569. In *Malat,* the taxpayer had participated in acquiring a parcel of land; the purpose of the venture was disputed by the parties; it was either to develop the land for rental purpose, to sell it, or perhaps merely to do whatever seemed most profitable in light of future events. When selling came to appear to be the most advantageous course, taxpayer sold. On those facts the lower court found, and the Court of Appeals agreed, that the primary purpose became one of selling, that the sale was not the liquidation of an investment, and that the income from the sale was thus ordinary income. In a brief opinion, the Supreme Court reversed and remanded for fresh findings of fact, giving its definition of "primarily" as "of first importance" or "principally." The Court expressly disapproved of lower court holdings in similar cases based on defining "primarily" to include "substantially." The Court added, "The purpose of the statutory provisions with which we deal is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand (*Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 52) and 'the realization of appreciation in value accrued over a substantial period of time' on the other. (*Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130, 134.)" *Id.* at 572.

When applied to this case, the two key pronouncements by the Court in *Malat*—with respect to the word "primarily" and to the purpose of the phrase "held by the taxpayers primarily for sale in the ordinary course of his trade or business"—appear to lead to conflicting results. On the one hand, generally speaking the purpose of selling its shoe machines was not of first importance to plaintiff. But on the other, the income from plaintiff's questioned sales arose from the everyday operation of the business and did not represent liquidation of an investment.

In *Corn Products Co.* v. *Commissioner*, 1955, 350 U.S. 46, the Supreme Court had occasion to discuss the broad policy factors underlying the capital gain provisions. There the taxpayer established a large position in corn futures in order to insure that it would have a supply of corn for use in its manufacturing operations. It sold or took delivery on the future contracts as it deemed expedient in light of the market supply. In upholding the lower court's conclusion that because the futures were bought as an integral part of the plaintiff's business operations, the futures were not capital assets, the Court asserted: "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or less rather than capital gain or loss. The preferential treatment . . . applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions,' *Burnet* v. *Harmel*, 287 U.S. at 106." 350 U.S. at 52. Although plaintiff asserts that *Corn Products* involved the definition of capital asset under the predecessor to 26 U.S.C. § 1221, and did not involve construction of the phrase "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," the plaintiff has minimized the significance of the Supreme Court's having specifically quoted from *Corn Products* in its *Malat* opinion, which did deal with that phrase, albeit in a § 1221 context.

Recognizing the impact on its case that application of the *Corn Products* principles would have, plaintiff contends that *Corn Products* should not be applied to a case arising under § 1231 but should be restricted to § 1221 cases. We do not agree. In the first place, the general

principles enumerated in *Corn Products* would be significant in any case where there is a question whether a business disposition of its products is to be accorded capital gain or ordinary income treatment. Secondly, the phrase in *Malat* that the Supreme Court construed, using *Corn Products* as one of its guides, is identical to the phrase in § 1231 which plaintiff invokes here. Sections 1221(1) and 1231(b)(1)(B) both exclude from capital gains treatment income realized from sales of "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . ." Thirdly, the Court of Appeals for the Ninth Circuit, in *Hollywood Baseball Assn.* v. *C.I.R.*, 9 Cir. 1970, 423 F.2d 494, held that *Corn Products* applies to § 1231 assets in an opinion analyzing a contrary holding in *Deltide Fishing & Rental Tools* v. *United States*, E.D. La. 1968, 279 F.Supp. 661.

One of the arguments advanced by plaintiff was apparently not presented to the court in the *Hollywood Baseball* case, namely, that after the *Corn Products* decision Congress enacted § 1245 in an effort to recoup losses in revenue due to capital gains treatment of certain sales of property on which taxpayers had taken depreciation deductions; and there would be no need for such a section if Congress had intended that the *Corn Products* decision apply to § 1231. See Note, 24 Vand. L. Rev. 181, 188 (1970). The difficulty with this argument lies in its premise that gains realized upon the sale of any and all property integrally related to the business will under the *Corn Products* case be treated as ordinary income. But the *Corn Products* decision should not be read so broadly. It would, for example, have no bearing on the sale of an oil drilling rig by an oil company, see *R. E. Cushing* v. *Commissioner*, 11 T.C. Mem. Dec. 396, or of logging equipment by a lumber company, see *F. M. Converse* v. *Earle*, 51-2 U.S.T.C. ¶ 9431. Assuming the other requirements in § 1231 were satisfied,

Corn Products would not operate to exclude income from the sales of such property from capital gains treatment. Therefore the application of the general *Corn Products* principles outlined above, re-asserted in *Malat,* is not inconsistent with the intent of Congress in enacting § 1245.

Returning to § 1231(b)(1)(B), the question becomes whether the fact that plaintiff's leased machines were, generally speaking, not held by the taxpayer primarily for sale to customers precludes applicability of the rule of the *Corn Products* case. We believe that it does not. If the apparent inconsistency should be irreconcilable, we believe that cases such as *Hollywood Baseball Assn.* v. *C.I.R., supra, Recordak Corporation* v. *United States,* Ct. Cl., 1963, 325 F.2d 460, and *Continental Can Co.* v. *United States,* Ct. Cl., 1970, 422 F.2d 405, indicate that the statutory provision should yield or be ignored. We would prefer to eschew the type of elaborate rationale found in those decisions and rely upon the principle of statutory construction of revenue laws stated in the opinion in the *Malat* case at 571-572, "Departure from a literal reading of statutory language may, on occasion, be indicated by relevant internal evidence of the statute itself and necessary in order to effect the legislative purpose."

We shall, however, make an effort at reconciliation. It seems to us that the plaintiff's general purpose of holding leased machines primarily for leasing them does not necessarily negate a finding that some of them were in fact held primarily for sale. The volume of previous sales of leased machines as an accepted part of the taxpayer's regular business together with growing competition made it predictable and indeed inevitable that substantial numbers of the machines out on lease would be sold. While the particular leased machines which would be sold could not be identified at any particular time before

sale, it may fairly be said after their sale that they had been held by the taxpayer primarily for sale. We do not consider that such an ex post facto aproach would be valid generally as, for example, in automobile and truck rental cases in which the sales of the rental equipment occurred as "the natural conclusion of a vehicle rental business cycle." *Philber Equipment Corp.* v. *Commissioner*, 3 Cir. 1956, 237 F.2d 129, 132, *Hillard* v. *Commissioner*, 5 Cir. 1960, 281 F.2d 279. But in our view it is appropriate in situations like the instant case where market forces induce the taxpayer to sell as well as rent its equipment long before it becomes obsolete in order to maintain its competitive position. See Bernstein, *"Primarily for Sale": A Semantic Snare*, 20 Stan. L. Rev. 1093, 1115-1116 (1968).

Finally, we rely upon the reasoning in the *Recordak* case, *supra*, at 463, as follows:

> Nor can plaintiff succeed by hitching its wagon to the word "primarily." Whatever the precise scope of that troublesome term in other contexts, it does not exclude from ordinary income the proceeds of sales by one, like plaintiff, who conducts a dual enterprise involving both rentals and sales of the same type of goods. In that setting, "primarily" invokes a contrast, not between selling and renting, but between selling in the ordinary course of business and selling outside of that normal course. Accordingly, if the entrepreneur holds out his wares either for sale or for rental, the taxation of his business gain from sales does not depend upon a comparison of sales to rentals in the particular year. . . . Regardless of that ratio, the goods are held "primarily for sale to customers in the ordinary course of . . . trade or business" because they are regularly offered for sale to customers as part of the normal operation of the enter-

prise. No case of this kind has allowed capital gains treatment.

Paraphrasing the quoted language, it seems to us that in this setting "primarily" invokes a contrast not between selling and leasing, but between selling and investing, whether the investment be in plant equipment or in the trading markets. The only reason that plaintiff normally leased its machines instead of sold them was that leasing was the more profitable method of disposition; plaintiff has not shown that its leasing business was investment-oriented or that its leased machines were converted involuntarily. Plaintiff has not suggested, and we do not think there is, any policy reason that would justify granting preferential tax treatment on the distinction that plaintiff normally leased, rather than sold, its shoe machines. Indeed, we believe that to grant such relief in the circumstances of this case would create a loophole in the capital gains provisions finding no support in legislative history.

Accordingly, judgment will be entered for the defendant.

(s) W. Arthur Garrity, Jr.
United States District Judge

APPENDIX C

United States Court of Appeals
For the First Circuit

No. 73-1337

INTERNATIONAL SHOE MACHINE CORPORATION,

PLAINTIFF, APPELLANT,

v.

UNITED STATES OF AMERICA,

DEFENDANT, APPELLEE.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

Before COFFIN, *Chief Judge*,
ALDRICH and MCENTEE, *Circuit Judges*.

Evan Y. Semerjian, with whom *James D. St. Clair* and *Hale and Dorr* were on brief for appellant.

Joseph M. McManus, Attorney, Tax Division, Department of Justice, with whom *Scott P. Crampton*, Assistant Attorney General, *James N. Gabriel*, United States Attorney, *Meyer Rothwacks*, and *Ernest J. Brown*, Attorneys, Tax Division, Department of Justice, were on brief, for appellee.

January 23, 1974

COFFIN, *Chief Judge*. Appellant taxpayer contends that the Commissioner of Internal Revenue erroneously treated income realized from the appellant's sales of certain shoe machines as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business", 26 U.S.C. § 1231(b)(1)(B), thereby taxing it as ordinary income instead of treating it under the capital gains provisions of the Code, and assessing deficiencies against the taxpayer. After having paid the deficiencies, the appellant filed claims for refunds, which were denied,

and then instituted the present case. The district court upheld the Commissioner's disposition.

It is undisputed that during the years in question, 1964 through 1966, appellant's main source of income derived from the leases of its shoe machinery equipment, rather than from their sales. The revenue from sales of the leased machinery comprised, respectively, only 7 per cent, 2 per cent, and 2 per cent of appellant's gross revenues. In fact, because the appellant preferred the more profitable route of leasing its machines, it never developed a sales force, never solicited purchases, set prices high to make purchasing unattractive, and even attempted to dissuade customers from purchasing them.

Yet the district court found that, beginning in 1964, when the investment tax credit made it more attractive for shoe manufacturers to buy shoe machinery rather than to lease it, the selling of machinery became an accepted and predictable, albeit small, part of appellant's business. Since appellant's chief competitor was selling leased shoe machines, it was necessary for appellant to offer its customers the same option. During the years in issue, appellant never declined to quote a price, nor did it ever decline to make a sale if the customer was persistent. Unlike previous years, purchase inquiries were referred to the appellant's vice president for sales, normally charged with selling new, non-leased machines, whereupon a price was negotiated. A schedule was prepared, indicating the sales price of leased machines, based upon the number of years that the machines had been leased. In total, 271 machines were sold to customers who, at the time of the sales, had been leasing the machines for at least six months.

The case raises what has become a repeating source of difficulty in applying § 1231(b)(1)(B), which denies highly favored capital gains tax treatment to "property held . . . primarily for sale to customers in the ordinary course of

his trade or business". In particular, does the word "primarily" invoke a contrast between sales and leases, as the appellant contends, or between sales made in the ordinary course of business and non-routine sales made as a liquidation of inventory? And, if the latter, how can sales made in the ordinary course of business be distinquished from a liquidation of inventory?

In support of its contention that "primarily" refers to a contrast between sales and leases, appellant relies upon *Malat* v. *Riddell*, 383 U.S. 569 (1966). There, the taxpayer purchased a parcel of land, with the alleged intention of developing an apartment project. When the taxpayer confronted zoning restrictions, he decided to terminate the venture, and sold his interest in the property, claiming a capital gain. The lower courts found, however, that the taxpayer had had a "dual purpose" in acquiring the land, a "substantial" one of which was to sell if that were to prove more profitable than development. Therefore, since the taxpayer had failed to establish that the property was not held primarily for sale to customers in the ordinary course of his business, his gain was treated as ordinary income. The Supreme Court vacated and remanded the case, stating that the lower courts had applied an incorrect legal standard when they defined "primarily" as merely "substantially" rather than using it in its ordinary, everyday sense of "first importance" or "principally". Although the Court in *Malat* was dealing with § 1221, rather than § 1231, the same clause appears in both sections. Appellant argues that the present case is analogous, since the "first" and "principal" reason for holding the shoe machinery was clearly for lease rather than for sale.

We cannot agree that *Malat* is dispositive. Even if "primarily" is defined as "of first importance" or "principally", the word may still invoke a contrast between sales made in the "ordinary course of . . . business" and

those made as liquidations of inventory, rather than between leases and sales. *Malat* itself concerned the dual purposes of developing an apartment complex on the land and selling the land. Although these two possible sources of income might be characterized as income from "lease" or "sale", a more meaningful distinction could be made between on-going income generated in the ordinary course of business and income from the termination and sale of the venture. *See Continental Can Co.* v. *United States*, 422 F.2d 405, 411 (Ct. Cl. 1970); *Recordak Corp.* v. *United States*, 325 F.2d 460, 463 (Ct. Cl. 1963).

We recognize that *Recordak*, invoking a contrast between "selling in the ordinary course of business and selling outside that normal course" was cited by the Supreme Court in *Malat* within a footnote which also listed the courts of appeals decisions then in conflict over the meaning of "primarily", *supra*, 383 U.S. at 571 n. 3. Given, however, that *Recordak* was not directly included within the list, but merely cited as a case which had also addressed the question, we think that *Recordak's* interpretation of the contrast invoked by the word "primarily" remains undisturbed by the Court's opinion. Beyond semantics, an additional justification for the interpretation becomes obvious when one applies appellant's logic to a not unrealistic business situation: to rest the word "primarily" on the distinction between lease and sale income would lead to the absurd result that whenever lease income exceeded sale income on the same item, the sale income could be treated as capital gain.

The real question, therefore, concerns whether or not the income from the sales of appellant's shoe machinery should have been characterized as having been generated in the "ordinary course of... business". Appellant contests the conclusion of the district court that selling was "an accepted and predictable part of the business" by

pointing out that sales were made only as a last resort, after attempts to dissuade the customer from purchasing had failed. We think that the district court was correct in its finding. While sales were made only as a last resort, it seems clear that after 1964 such sales were expected to occur, on an occasional basis, and policies and procedures were developed for handling them. Purchase inquiries were referred to the vice president for sales, a price schedule was drawn up, and discounts wre offered to good customers. Appellant may not have desired such sales. It is likely that appellant would never have developed a sales policy for its leased machines had it not been forced to do so by the pressure of competition. But it was justifiable to find that such occasional sales were indeed "accepted and predictable".

Even "accepted and predictable" sales might not, however, occur in the "ordinary course of . . . business". For example, a final liquidation of inventory, although accepted and predictable, would normally be eligible for capital gains treatment. Appellant's final contention, therefore, is that the sales in question represented the liquidation of an investment. Appellant points out that the machines were leased for an average of eight and one half years before they were sold, during which time depreciation was taken on them and repairs were made. Thus, appellant seeks to bring itself within the scope of the "rental-obsolescence" decisions, which hold that the sale of rental equipment, no longer useful for renting, is taxable at capital gains rates. *Hilliard* v. *Commissioner of Internal Revenue,* 281 F.2d 279 (5th Cir. 1960); *Philber Equipment Corporation* v. *Commissioner of Internal Revenue,* 237 F.2d 129 (3d Cir. 1956); *Davidson* v. *Tomlinson,* 165 F. Supp. 455 (S.D. Fla. 1958).

In the "rental obsolescence" decisions, however, equipment was sold only after its rental income-producing

potential had ended, and "such sales were the natural conclusion of a vehicle rental business cycle". *Philber, supra,* 237 F.2d at 131. Moreover, the equipment was specifically manufactured to fit the requirements of lessees; it was sold only when lessees no longer found the equipment useful. *Id.* In the present case, however, the shoe manufacturing equipment was sold, not as a final disposition of property that had ceased to produce rental income for the appellant, but, rather, as property that still retained a rental income producing potential for the appellant. Had appellant chosen not to sell the shoe machinery, the machinery would have continued to generate ordinary income in the form of lease revenue. Thus, the sale of such machinery, for a price which included the present value of that future ordinary income, cannot be considered the liquidation of an investment outside the scope of the "ordinary course of . . . business".

Affirmed.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 73-1337

INTERNATIONAL SHOE MACHINE CORPORATION,
PLAINTIFF, APPELLANT,

v.

UNITED STATES OF AMERICA,
DEFENDANT, APPELLEE.

JUDGMENT

Entered: January 23, 1974

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgments of the District Court are affirmed.

By the Court:
(s) DANA H. GALLUP
Clerk.

[cc: Messrs. Semerjian and McManus.]

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 73-1337.

INTERNATIONAL SHOE MACHINE CORPORATION,
PLAINTIFF, APPELLANT,
v.
UNITED STATES OF AMERICA,
DEFENDANT, APPELLEE.

Before COFFIN, *Chief Judge*,
ALDRICH and MCENTEE, *Circuit Judges*.

MEMORANDUM and ORDER
Entered February 25, 1974

Petitioner has with tenacity called our attention to a number of alleged misstatements of fact and misconstructions of cases. As to the former, we have reviewed the record which, while containing selective support for petitioner's version of the facts, also supports our summary. Our reference to the necessity that appellant "offer" a sale option to customers adopts the language from an affidavit used in examination. Perhaps "make available for sale" would have been more clear, but no legal conclusion turns on the nuance. As to the business necessity compelling the sale option, petitioner argues that the fact that its competitor was selling was not the critical factor; but such testimony as that "our attitude was that all things being equal, we had to beat United to get the business" and "we didn't want to lose the sale to [our] competition" supports our view and that of the district court that competitive forces dictated the policy to make sales an available option.

A further challenge is made to our (and the district

court's) characterization that after 1964 sales procedures were more routinized, after a decision was made that sales would be made on a non-discriminatory basis if any shoe manufacturer insisted. While appellant's attitude remained that of a reluctant seller, decisions could be made at less than the highest level. Petitioner seeks to discount the meaning of testimony that "thereafter" (i.e., after 1963-1964) top level consultation was not necessary. Whether or not entirely new procedures distinguished the new era from the old, the essential fact is that there was, by force of the basic policy decision, some normalization of the sales operation.

Petitioner also takes issue with our observations, as not being founded on evidence, that if machines were not sold they would have continued to generate lease income and that sales prices included the present value of the otherwise expectable future lease income. These statements represent not very startling economic assumptions. If the machines were priced high enough to include the present value of future income, our statements were justified. If, however, they were sold at less than such value, then appellant is in a worse position, in that it would have been encouraging sales at sacrifice prices.

Petitioner also contests our view—irrelevant to its own situation—of the capital gains eligibility of a liquidation of inventory in a winding up context; of our interpretation of *Malat* v. *Riddell*, 383 U.S. 569 (1966), and of our analysis of certain decisions which we have treated as "rental-obsolescence" cases. Several of petitioner's points are restatements of arguments already made. See our rule 15. Nothing in the petition persuades us to change our views.

The petition is denied.

By the Court:

(s) DANA H. GALLUP

Clerk.

[cc: Messrs. Semerjian and McManus.]